Managing SME Investment Funds

in Latin America and the Caribbean:

Lessons Learned and Recommended Best Practices

A Report Submitted in Conjunction with the Multilateral Investment Fund's (MIF) Workshop on Small and Medium Sized Enterprise Investment Funds in LAC

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By SOLANA INCORPORATED *

***The principal author of this report is Marie Gunning/ Portland, Maine**
(mgunning@solana-inc.com)

MANAGING SMALL AND MEDIUM SIZED ENTERPRISE INVESTMENT FUNDS IN LATIN AMERICA AND THE CARIBBEAN:
LESSONS LEARNED AND RECOMMENDED BEST PRACTICES

Prepared by:
Marie Gunning
SOLANA INCORPORATED
120 Exchange Street
Portland, ME 04112[1]

EXECUTIVE SUMMARY

Over the past decade, private investment funds have emerged as a potential new financing option for small and medium sized business enterprises ("SMEs") in Latin America and the Caribbean ("LAC"). The Multilateral Investment Fund ("MIF"), a special fund administered by the Inter-American Development Bank, has been a prime catalyst behind piloting this new type of financing vehicle. To help track the impacts of its investment fund support, the MIF requires all investment funds in which it is a participant to be subject to periodic review by outside investment professionals. These independent monitoring evaluations provide an objective assessment of the operating aspects of each fund, and help to identify major trends common throughout the region's nascent SME private investment market.

Drawing from the findings of monitoring evaluations conducted for the MIF and others between 1996 and 2003, this paper sets forth some of the key lessons learned to-date from the operation of various LAC- based SME investment funds. These conclusions are based upon examination of market standards for the region, as well as actual examples encountered through the independent monitoring review process. It is hoped that this summary will help fund managers, fund governance bodies and potential new fund investors enhance their SME financing activities in LAC.

[1] Ms. Gunning is the President of SOLANA Incorporated, a business consulting firm which provides investment due diligence and investment monitoring & evaluation services for global investors.

The topics reviewed in this paper are grouped around two core areas of fund management activity: fund administration and investment operational practices.

Section One of the paper covers those issues associated with investment fund administration. The four major areas of administration processes and procedures covered in this section of the paper can be summarized as follows:

- **Internal Administration**

  The current market practice for many LAC SME investment funds is to split the fund's administrative matters between an investment fund manager and an investor appointed Board of Directors. Under this type of internal framework, some of the essential ingredients for effective administration are:

  Investment Experience – Results to-date suggest that there is a higher likelihood of success among SME funds which are staffed by individuals who have proven experience in business and financial transaction work, especially hands-on experience in deal analysis and structuring. Also important is that the fund management team[1] have at least a working knowledge of LAC-based financial customs and norms.

  Independence – Experience has also demonstrated that it is critical for a fund's administrative and governance structures to be sufficiently independent of each other. In particular, the composition of the fund's Board of Directors and internal advisory committees should be sufficiently independent of the fund manager to provide the fund and its investors with impartial, objective oversight. This is a particularly significant issue for LAC-based SME funds, due to the region's traditional preference toward conducting closely held business financing transactions with "insiders" (e.g. family members, friends and close associates).

  Conflicts of Interest – To-date, LAC's small equity funds have used a variety of different structural mechanisms to address the issue of potential conflicts of interest within fund operations. These mechanisms include policies which require disclosure and approval by independent Board members of any type of related party transaction; the establishment of a separate conflicts of interest oversight committee responsible for the review/approval of all related party transactions;

[1] *In this context, the fund's administrative team is defined as consisting of the fund manager, Board of Directors and all oversight committees*

and, the use of by-laws which require the fund manager, Board members and others to submit annual certified disclosure statements on all related party transactions. As illustrated by the case examples presented within the paper, for these types of mechanisms to be effective, investment funds also need to adopt active oversight procedures.

Reinforcement of Core Operating Principals – LAC's SME fund managers have learned through experience the value of insuring that there is regular and clear communication regarding the fund's specific standards, regulations and operating guidelines. Communication and the implementation of solid mechanisms to confirm the fund's on-going compliance with all stated policies are essential to assuring that the fund's administrative team meets its core fiduciary responsibilities.

Board and Committee Meetings – The operating results of various LAC SME funds have demonstrated the value of increasing the frequency and rigor of fund Board and advisory committee meetings. Oversight committee meetings which allow for frank, in-depth discussion of fund activities are especially important for effective fund administration.

Operating Reporting – Clear and adequate operating reporting is another key ingredient for strong, effective fund administration. Looking at the experiences of various LAC based funds, the paper finds that a fund's internal administration can be strengthened by expanding the level of reporting provided by the fund management team, particularly as it relates to bank account information, cash management activities, fund signing authorities and investment placement practices.

- **Investor Oversight of Fund Activities**

  This component of the paper discusses the wide variability in direct investor oversight which is typical with LAC SME fund activity. After considering some of the factors which contribute to this variability, the paper presents several recommended best practices for fund investors interested in enhancing their fund oversight activities. These tips cover investors' use of audited financial statements, the establishment of performance benchmarks for management, and the use of independent, third party reviews.

- **Fund Accounting and Financial Management**

  Financial management and internal fund accounting issues are important administration functions and are covered in some depth in the body of the text. The paper uses various case examples to highlight the importance of requiring fully transparent financial management practices. Identified as added concerns are the need for full reporting on the transfer of all fund assets, the importance of requiring stand-alone fund accounts, and the tracking of portfolio foreign exchange risks.

- **Support Received from Related Parties**

  The final topic presented under the investment fund administration section of the paper covers the handling of fund support received from related parties. The paper outlines how beneficial this type of support has been for certain funds and provides several best practice recommendations for assuring appropriate management of such situations. These recommendations include assuring that all support be provided on a fully transparent basis and be provided by parties with sufficient knowledge and expertise; that the pricing for any fee-based services should be priced at market rates; and, that funds obtain signed hold harmless/indemnification agreements from their investee companies for all related party activities.

Section Two of the paper looks at the operational activities of typical LAC-based SME funds. These activities range from identifying potential fund investment opportunities, to structuring an investment deal and monitoring its performance, to exiting the investment transactions and, hopefully, recouping the fund's monies with a reasonable rate of return. The success of SME investment funds operating in LAC has, to-date, varied widely. Some funds have done relatively well in their efforts at providing financing support to small and medium sized businesses. Others have not. Using lessons learned from this wide range of experience, the paper presents some key observations related to the disparity in fund operating results. The issues covered include:

- **Pipeline Development Activities**

  Many of LAC's SME investment funds have faced higher than expected pipeline development costs and slower than expected rates of actual investment disbursement. Given the costs of this trend to funds, a number of suggestions are presented to help improve the efficiency of the investment pipeline development process. These include review of the fund's screening tools; examination of the key sources of new investment leads; and, implementation of a staff productivity tracking mechanism.

- **Investment Level Projections**

  An issue frequently identified among investment funds is reliance on overly optimistic financial projections in conjunction with the investment decision making process. In response to this trend, the paper puts forth several best practice recommendations related to investment level financial modeling. These include the importance of "ground-truthing" investee company financial projections as part of the investment review process; benchmarking projected financial results against established industry data; and, explicitly testing the viability of the fund's expected exit mechanism on each transaction.

- **Due Diligence on Potential Investee Companies**

  In conjunction with realistic financial modeling and investment structuring techniques, conducting solid due diligence on a proposed investee company is one of an investment fund manager's most important responsibilities. Accordingly, the paper presents several suggestions and case examples regarding sound due diligence practices. These include the importance of not being presumptive about a prospective investee company's performance; conducting detailed, in-depth reviews of a company's operations; and, the identification of potential red flags within a prospective investee company's financial statements.

- **Deal Structuring**

  Various aspects of successful investment deal structuring practices are identified and discussed within this section of the paper. These include case examples demonstrating the use of successful fund pricing strategies, deal terms and documentation procedures.

- **Monitoring and Supervision of Investee Companies**

  The paper also looks at some of the principal monitoring and supervision issues associated with SME investment financing transactions in LAC. These include the importance of well documented disbursement procedures; the need for close tracking on the use of fund investment monies; and, the value of active deal monitoring, via effective company site visits.

- **Follow-on Investments**

  Also discussed are some of the challenges inherent in making successful follow-on investments among SME companies. Included is a short list of questions a fund manager may wish to review as part of its decision-making process on follow-on advances.

- **Liquidations and Other Exits**

  Other operational issues discussed in the second section of the paper include factors to consider when evaluating a potential turn-around situation for an investee company, the liquidation of investee companies, and the importance of portfolio diversification. As detailed within, strong Board and/or investor oversight is a critical ingredient for each of these areas of operation.

In summary, the enclosed best practices paper provides insights into many of the administrative and operational issues associated with SME private investment funds in LAC. Using the findings of past fund reviews, the paper provides investment fund managers, Board members and private investors with a variety of suggested tools and strategies to advance the implementation of non-traditional private financing for small and medium sized businesses in LAC.

INTRODUCTION

Over the past decade, private investment funds have emerged as a potential new financing option for small and medium sized businesses in Latin America and the Caribbean ("LAC"). The Multilateral Investment Fund ("MIF"), a special fund administered by the Inter-American Development Bank, has been a prime catalyst behind piloting this new type of financing vehicle. This has been particularly the case among funds targeting their financing to small and medium sized business enterprises ("SMEs"). Through its Small Enterprise Investment Fund Program, the MIF has made over $173 million in equity type financing commitments. This investment has, in turn, leveraged an additional $294 million in SME funding support from almost 50 other co-investors.

To track the impacts of its investment fund support, the MIF requires all investment funds in which it is a participant to undergo a periodic review by outside investment professionals. These independent monitoring evaluations provide an objective assessment of the operating aspects of each fund, and help to identify major trends common throughout the region's nascent private investment market.

Drawing from the findings of monitoring evaluations conducted for the MIF and others between 1996 and 2003, this paper summarizes some of the major lessons learned to-date from the operation of various LAC based investment funds. These conclusions are based upon examination of market standards for the region, as well as actual case studies encountered through the independent monitoring review process. The format of this paper is organized around the two core areas of investment fund management activity: fund administration and fund level operational practices. It is hoped this summary review will help fund managers, fund governance bodies and potential new fund investors enhance their SME financing activities in LAC.

1.0 INVESTMENT FUND ADMINISTRATION

The administration of small private investment funds in LAC is typically split between investment management functions and fund governance related activities. These responsibilities can be summarized into four general categories of administration processes and procedures: (1) **Internal Administration**, (2) **Investor Oversight of Fund Activities**, (3) **Fund Accounting and Financial Management**, and (4) **Fund Support Received from Related Parties**. The following is a brief description of each of these critical functions, along with examples of common experiences encountered in their execution.

1.1 INTERNAL STRUCTURE OF LAC SME FUNDS

Fund experience indicates that the operational policies and procedures adopted by a fund can be a critical determinant of its success. The current market practice for many LAC based SME investment funds is to establish a structure in which administration is split between an investment fund manager and an investor appointed Board of Directors (or, "Board"). Under this type of framework, the fund manager typically has responsibility for the fund's day-to-day operations. This includes the provision of back-office administrative support, internal fund accounting services, deal identification, analysis and structuring, investment placement, collection and monitoring activities, and Board, investor and regulatory reporting. The fund's Board of Directors is, in turn, given lead oversight responsibility for fund related activities. This includes oversight of the fund manager's activities, review of the fund's budgets and financial reports, and assuring fund compliance with all required policies, procedures and regulations.

To augment this basic fund administration framework, many LAC investment funds also establish specialized support committees to provide advice and oversight on specific issues. For instance, funds may establish a separate investment advisory committee, which is responsible for the review and approval of all proposed fund investments. Other, common fund advisory committees include an investment valuation committee (responsible for periodically reviewing/approving the carrying values of the fund's investment portfolio), a conflicts of interest committee (responsible for reviewing all fund transactions which have a potential related

party component), and other specialized technical advisory committees (responsible for providing policy advice on specific investment related topics or issues, such as the bio-diversity related aspects of a fund's investments).

Based on the operating experience of various LAC investment funds, under this type of general structure key considerations in assuring effective internal fund administrative practices include:

Investment Experience

Results, to-date, suggest the most successful private investment funds operating in LAC are staffed by individuals who have proven experience in business and financial transaction work, particularly in the area of deal analysis and structuring. An investment fund can (and should) contract with outside experts for investment support services, such as legal advice, specialized technical reviews and asset management support. However, the investment review and placement process is a core management responsibility which is generally not contracted out to third parties. As such, it is difficult, if not impossible, for an investment fund to be successful if its fund manager, investment committee members and Board do not have sufficient financial and risk analysis experience. At this relatively early stage of the market's development, the learning curve for small enterprise private financing in LAC is simply too steep for an administrative team which lacks sufficient hands-on financing experience.

In addition to actual investment experience, the region's fund managers have learned that it is very important for all fund members to have at least a good working knowledge of LAC based financial customs and norms. This is due to the fact that LAC, as a region, has its own distinct business characteristics and financing related subtleties. Although there are some similarities between the LAC SME investment model and traditional U.S. and European venture capital finance, there are investment terms used in those latter markets that do not work particularly well in Latin America. Accordingly, the more knowledge and experience the fund's manager, Board of Directors and advisory committee members have with LAC based business transactions, the better the odds of success are for any particular fund.

Independence of Fund Administration

LAC's fund managers have also learned that it is critical for a fund's administrative/governance structure to be sufficiently independent. In particular, the composition of a fund's Board of Directors and internal advisory committees need to be independent enough of the fund manager (and any other related parties) to be able to provide the fund and its investors with impartial, objective oversight. While this is a typical concern for most private investment funds, it can be a particularly significant issue within LAC, due to the region's strong cultural tradition of conducting closely held business financing transactions with "insiders" (e.g. family members, friends and close associates). As a result of this tradition, an emphasis on full disclosure and complete transparency on potential conflicts of interest is somewhat newer in LAC, especially among small enterprise financing transactions.

One example of this was noted at a small LAC fund, in which all of the investment advisory committee members were employees of the fund management company. Not surprisingly, every investment the fund manager submitted to the investment advisory committee was approved without discussion or change. In another situation, the investment committee of a small LAC fund was structured so it would consist of two fund manager employees and three "independent" members. However, in practice, it was staffed so that a majority of the independent members of the committee were actually associates or employees of companies related to the fund manager. In another instance, the members of a fund's valuation committee, which had a central role in establishing the valuations for the fund's investment portfolio, were all close associates or good friends of the fund manager.

While these types of situations are not necessarily the norm for all LAC SME funds, they underscore the importance to investors of taking an active role in reviewing the composition of the administration team members responsible for overseeing a fund's activities.

Experience indicates LAC investment funds which do not establish strong separations between members of the various functions of the fund's administration[2], often face some of the biggest challenges to effective investment management.

Managing Conflicts of Interest

In recent years the topic of transparency and disclosure of potential conflicts of interest has become a prominent operating issue throughout the global financial marketplace. Private fund investors have become especially attuned to this issue. Investors are increasingly demanding full transparency on any matters involving potential conflicts of interest among fund managers, the fund's Board members and any advisory committee members who assist in fund oversight. To-date, LAC's small equity funds have used a variety of different structural mechanisms to address the issue of conflicts of interest in fund operations. These include policies which require disclosure and approval by independent Board members of any type of related party transaction; the establishment of separate conflicts of interest oversight committees responsible for the review/approval of all related party transactions; and, the use of by-laws which require the fund manager, Board members and/or others to submit annual certified disclosure statements on all related party transactions.

A potential risk with some of these approaches is that self-reporting provisions are not always well adhered to by all management parties. For instance, one SME equity fund had by-laws and management agreements which specifically required disclosure by the fund manager to the Board of any transactions with related party entities. In practice, however, the fund did make investments in companies with clear related party interests, but the fund's Board was not aware of these because the required disclosures were simply not made as agreed. In another instance, one LAC fund manager recommended that the fund it was managing invest in a company which was controlled by another fund, which it was also managing. This clear conflict reportedly was verbally identified to the fund's investment committee, but never identified, as required, to the fund's Board. As a result, at least some members of the fund's Board were not aware of the issue until an outside, independent review of the transaction raised the issue.

[2] Defined as the fund manager and the fund's Board and oversight committees.

The main lesson learned from these and similar lapses, is that self reporting disclosure policies provide a good foundation for fund operations, but to be effective, they need to be coupled with active oversight mechanisms. Such mechanisms may include requiring regular third party certification reports (such as an annual statement of all conflicts/related party transactions certified by the fund manager and/or its external auditors); proactive questioning by the fund's advisory committees about possible conflicts of interest on each fund investment; periodic independent portfolio and/or sample investment reviews; and, the introduction of by-law provisions which specifically exclude failure to disclose insider transactions from the fund manager's indemnification agreement.

Reinforcement of Core Operating Principals

LAC's SME fund managers have learned through experience that another important consideration for promoting effective fund administration is clear communication of the fund's policies and operating standards. Past operating results have demonstrated that (1) a fund's regulations and guidelines need to be clearly and regularly communicated to all parties involved in fund administration, and (2) that solid mechanisms are needed to assure on-going compliance with these policies. As rudimentary as this may seem, it is not uncommon for small investment funds to unwittingly slip into non-compliance with at least some of the requirements established under their investment agreements. Even on requirements which may seem minor or insignificant, assuring compliance with the fund's own policies and procedures is a key fiduciary responsibility for both its fund manager and its Board of Directors. As such, these issues need to be closely tracked by all members of the fund administration team.

One approach to reinforcing the importance of compliance tracking is for the investment fund to maintain a clear, written list of all of the regulatory, operating and reporting requirements outlined under its investment agreements, grant facilities and regulatory documents. This list can then be consulted in conjunction with every major decision passed by the fund's Board (e.g. as part of the fund's investment process), and can be used as a tool to affirmatively certify to the Board that the fund is in adherence with all of the stated requirements. A fund's Board can also

request that copies of the operating requirements list be provided to the fund's external accountants, legal counsel, and others providing support services so that they can monitor for areas of non-compliance as well. Ultimately, each fund needs to implement some type of mechanism(s) to track its compliance with the operating and reporting requirements established under its Shareholder Agreement, by-laws and related facility agreements.

Board and Committee Meetings

The operating performance of various LAC SME funds suggests that increasing the frequency and rigor of a fund's Board and advisory committee meetings can also greatly enhance fund administration. For instance, certain small LAC funds have reported regularly to their respective Boards on not only proposed new investments, but also the operating status of previously approved investments. These fund managers use the up-date process as a proactive means of gaining candid feedback on deals and for identifying areas of potential concern on their investments. In comparison, other funds have had Boards which meet only two or three times per year. This type of schedule usually provides only enough time to cover the "big picture" aspects of the fund's operations and is usually not sufficient for Board members to obtain an in-depth level of understanding of the fund's operating activities. As a result, the Board's ability to effectively monitor and oversee the fund manager's activities is diminished. Overall, experience strongly suggests that a SME fund's Board should meet as frequently as possible and supplement lack of on-site meetings with frequent conference call meetings.

Another distinguishing feature for some funds has been the use of Board meetings which include open, frank discussions on fund operations and investment status. Meeting minutes for these funds indicate a healthy level of open discussion and questioning among Board members is common. In contrast, are those Board meetings which are conducted with more of an emphasis on public relations, rather than the nitty-gritty of fund operations. This type of meeting is typically long on "gloss" and relatively short on detailed, in-depth specifics about the fund's activities/challenges. As such, they typically do little to enhance a Board's oversight role.

Operating Reporting

The region's SME fund managers have learned through experience that clear, adequate operating reporting is another important ingredient for strong, effective fund administration. Often minimum reporting requirements for fund managers are established at the front-end, or start-up, of an equity fund. These typically include provisions requiring annual audited financial statements, annual fund budget reports and on-going investment disbursement summaries. Regular reports on other related matters, such as pipeline development activities and disbursement projections, are not always explicitly required under standard fund management agreements, but are also commonly provided.

Looking at past experience, examples of additional fund operating information which are important to track include:

- **Reporting on Fund Accounts**
  - **Bank accounts**. Over the years funds have learned of instances in which bank accounts were established without the knowledge or consent of their Board. For all involved parties, this is a poor practice, from both an operating and a legal risk perspective. To help prevent this type of oversight lapse, it is useful for a fund's administration team to periodically submit for Board approval a master list of all fund accounts. This should include a list of the accounts' physical locations, their recorded names and account numbers, and their authorized account signers.

  - **Cash management activities.** As with fund bank accounts, it is very beneficial for the fund's administration team to periodically prepare an updated list of all cash management account information (account name, number and location, transaction making authorities, cash management policies, and information on cash management costs and account returns).

    Some investment funds may have very little cash management needs, while others have large cash management requirements (especially in the early years of the fund's activities). In either case, it is not unusual for a fund's Board and investment committee to be given very little detailed information on the fund's cash management activities. Based on past experience, this practice can lead to insufficient oversight over the fund's assets. For instance, there is the example of one fund which provided its Board with a short quarterly summary of its cash management account activity. However, the summary lacked a number of details about the flow of funds in and out of the cash management account. When a more detailed assessment of the account's activities was conducted in conjunction

with the fund's independent monitoring review, several lapses in the handling of the cash management account were identified. The key lesson learned from this and other, similar examples, is that the fund's Board and oversight committee members are best served by obtaining detailed information on the activities taking place within all cash management accounts.

Information on the financial condition of the institutions(s) which hold the fund's liquid assets is also valuable for a fund's administrative team. In all markets, there is always a risk that a financial institution could experience unexpected financial difficulties, or be subject to regulatory intervention. For this reason, periodic review of the stability of the institutions holding the fund's cash management assets is good management practice.

Suggestions for mitigating the institutional risk on fund cash management accounts include:

- When possible, place fund assets only in well capitalized/well rated financial institutions.

- Avoid institutions which have a reputation for taking aggressive market positions (especially important for local stock houses). Even if a fund's cash management assets are not, themselves, invested in high risk investments, the fund can suffer indirectly if its cash management house becomes unstable due to an excessive amount of high risk assets.

- In markets experiencing high economic volatility, periodically complete regular reviews of the institution's financial condition.

- In high risk situations, diversify the fund's cash holdings among two, or more, financial institutions.

■ **Use of "umbrella" asset accounts**. For fund managers managing more than one portfolio, it is a relatively common practice to aggregate different operating accounts under a single umbrella, or master account. One problem which frequently occurs with this type of approach is that a fund may be overcharged fees or expenses related to its share of the master account management. In addition, there can be instances in which erroneous or improper transfers occur among the various sub accounts structured in this fashion. For these reasons, experience indicates the use of umbrella type accounts among investment funds should be strongly discouraged. In those instances in which investment fund assets are being held in any type of aggregated account, it is very important for the fund's Board and oversight committees to receive full information on the flow of funds through the account. As part of this process, the Board should also periodically confirm that its fund is not paying any additional bank fees or other costs for the shared account.

- **Reporting on Fund Signing Authorities** – In most cases, an investment fund's Board must formally authorize an individual(s) to execute binding documents on behalf of the fund. Investment managers and their Boards typically do a very good job in meeting this responsibility at the onset of the fund. One area which can be subject to slippage, however, is the removal of the signing and representation powers of the designated individual(s) if they are no longer associated with the fund. For instance, one regional SME fund established two South American bank accounts and, for logistical reasons, several members of the fund manager's local staff were listed as authorized signers on the accounts. Two of those employees subsequently resigned their positions with the fund to take jobs elsewhere. However, more than a year after their resignations, each was still listed as a valid signatory able to make transactions on the fund's accounts.

  The risks associated with this type of common mistake can be eliminated by establishing a standard process, under which the fund's Board is periodically provided with an updated list of (1) all individuals which can sign/execute documents on behalf of the fund and (2) all those who are authorized to sign or otherwise access any of the fund's accounts. By scheduling this as a regular Board agenda item, it reminds both the fund manager and the Board of the need to make any necessary updates.

- **Reporting on Fund Projections** – As part of the fundraising process, investment fund sponsors often prepare detailed projections on the proposed fund's expected financial results. These projections typically include estimates on total equity capital raised, rates of investment disbursement, fund operating expenses, projected investment returns, and expected fund/investor rates of return. Once the investment fund is capitalized and operating, the fund manager will inevitably make revisions and adjustments to the original forecasts to reflect the fund's actual operating results. These projections are important to both the fund manager and the fund's Board, as they help provide a "big picture" understanding of the fund's activities and results. Based on past operating experience, fund administration is usually enhanced greatly when fund managers issue timely updates to these types of forecasts. Such updates should clearly articulate not only

the updated projections, but also how they compare with the original forecasts presented at the onset of the fund. Tracking fund projections/results against only previously revised projections (and not original forecasts) is not particularly effective.

- **Reporting on Closed Investment Transactions** – The investment making process for LAC based SME funds typically requires that all proposed investments be approved by the fund's Board and/or Investment Advisory Committee. Past experience indicates this process is typically well coordinated by the fund's investment fund manager. One area where there can be slippage, however, is when the structure of the investment transaction changes subsequent to Board (or oversight committee) approval. Based on the experiences of various investment funds, it is not uncommon for funds to make investments with different terms than those that were approved at the committee level. In addition, many times those changes are not communicated back to the appropriate oversight bodies.

  For instance, one fund's investment committee approved a transaction based on the premise the fund would obtain a real estate mortgage as partial collateral for the investment transaction. Subsequent to the investment's approval, the fund manager decided it would be more cost effective not to take the proposed mortgage, but it did not advise either the investment committee or the fund's Board of the change. Similarly, on another fund, the investment structure approved by the Board required the investee company to achieve certain performance related benchmarks prior to additional fund monies being disbursed. When the investee company subsequently did not meet the agreed upon goals, the fund manager opted to waive the performance requirements and simply continue disbursing investment funds. This change in investment terms was also not communicated back to the fund's Board for its approval.

  In most instances, the failure to communicate changes in a deal's final terms or investment structure reflects the fact that fund managers are juggling many different management responsibilities and are generally not asked to report back to the fund's

oversight bodies on the specifics of their closed investments. As a result, they typically report back only on whether or not deals closed, and if the allocated funds were disbursed. For these reasons, it is valuable for funds to have a structured post-disbursement process which includes reporting on the specific terms and structure of the investment made. It is also incumbent upon a fund's Boards to emphasize to fund management, that any exceptions to the fund's investment policies or initial investment approvals be reported immediately.

- **Reporting on Investment Related Legal Documentation** – Investment fund managers have a fiduciary responsibility for properly managing their fund's assets, including maintaining the legal documents associated with each investment disbursement made. A fund's Board is also responsible for seeing that these requirements are appropriately managed. As such, the tracking of a fund's investment related legal documentation is an important reporting requirement.

  Based on past experiences, it is not unusual for there to be gaps in an SME fund's legal documentation tracking process. In particular, in past instances investment documents (e.g., investee company shareholder agreements and share certificates; loan and collateral agreements) have been found to be missing, incomplete and/or improperly executed. Given the potential risks and fiduciary liability associated with such lapses, a key lesson learned has been that use of a basic legal document tracking report should be a high priority for all LAC funds. Ideally, such reporting will be reviewed with the fund's Board or oversight committees on a regular basis.

Independent Fund Reviews

Finally, experience to-date indicates there is strong value to retaining independent third party professionals to conduct evaluations of a fund's internal administration. Savvy investors have learned through experience the value of requiring regular, periodic independent assessments of the funds in which they invest. Such reviews can provide the fund manager, the fund's Board and the fund's investors with an objective evaluation of the fund's operating strengths and

weaknesses, as well as an independent opinion on the potential value of the fund's investment portfolio. In doing so, the independent review process provides important checks on how well the fund is doing, both with regard to its internal policies, procedures and goals, and also relative to the operating investment performance of peer funds.

Third party reviews can take any number of different formats. These range from a full, on-site evaluation (including investee company site visits), to desk review of the fund's activities and investments, or having the independent third party participate in fund Board or investment committee meetings. If properly structured, the value added from a third party review will more than offset the added operating cost to the fund.

1.2 INVESTOR OVERSIGHT OF FUND ACTIVITIES

As noted above, experience has shown it is important that an equity fund be structured to assure that its operations and investments are administered by experienced, independent professionals committed to the highest standards of reporting and operating transparency. Achieving these parameters within the fund management, Board of Directors and advisory committee components of a fund's administrative structure is a critical step to establishing the foundation necessary for a LAC based fund's success. Also important in this process, is establishing policies and procedures which enable the fund's investors to have a productive oversight role in the fund's operations.

To-date, the level of direct investor oversight of LAC's SME funds has varied widely. Some investors have taken a very active role in monitoring and reviewing their fund's operating activities; others have taken a more passive approach to oversight. Some of this reflects the wide disparity in the amount of investment monies committed by SME fund investors. Also a factor, has been the time and cost needed to conduct oversight by non-local investors. With these factors in mind, the following is a short list of basic procedures which all investors in LAC SME equity funds can draw upon to optimize their oversight activities.

Investor Use of Audited Financial Statements

Generally, it is standard practice for investment funds to provide their limited partner investors with at least an annual audited financial statement of the fund's activities. Such statements are an important oversight tool for investors, subject to several important caveats. First, audited financial statements are not a "guarantee" that the fund is being managed in compliance with all of its contractual or even regulatory requirements. There have been numerous cases in which funds were *not* in compliance with certain aspects of their investment agreement or regulatory provisions, and this was not picked up in the fund's audited financial statement. For instance, it is very common for audited financial statements to report the total amount of fund monies allocated to fund management fees in one year. They do not, however, note if the fees were paid according to the terms of the fund management agreement. As a result, there have been a number of different instances in which a fund manager was either paid more than the amount agreed to in its fund management agreement, or the management fee was not paid according to the terms outlined in the underlying agreement. These and other similar issues underscore that an investment fund's audited financial statements can provide an investor with certain level of comfort on fund operations, but that compliance assurances are not typically a standard part of an external accounting auditor's scope of work.

Other, specific issues for investors to consider when using their investment fund's audited financial information as an oversight tool include:

- Always request a full copy of the fund's *final* audited financial statement. This report should include the auditor's opinion letter (and any qualifications made to the same) and all of the financial statement footnotes. Do not accept in lieu of the final annual financial statement any reports which have been issued as preliminary, or draft copies. These types of statements are subject to change and can cause an investor to miss important subsequent adjustments.

- If possible, request that the scope of the fund's annual external audit include management letters and that the fund manager provide copies of all management letters issued by the fund's accountants. These letters provide information on specific issues or concerns the auditor may have noted during the audit process.

- Make note of both the scope (or type) of audit review conducted and the audit standards applied. Some LAC equity funds may have audits conducted under standards other than Generally Accepted Accounting Principles (or GAAP), and this can impact materially on how the fund's results are reported. It is also very important for an investor to know whether or not the auditors completed a full on-site examination of the fund's books and records (particularly if the fund is being managed from more than one office). In the past, there have been instances of funds which, for cost considerations, limited the external accountants' physical audit to only the accounts located in one office location (e.g., the accountants did a physical review of only the books and records in the fund manager's U.S. office, and did not complete a full review of its LAC office). Thus, some fund records were actually not subject to a full on-site audit assessment. Investors need to keep this risk potential in mind as they review the fund's statements.

Investor Use of Fund Meeting Minutes

In addition to review of a fund's audited financial statements, investors with an interest in tracking the operation of a small investment fund are usually well served by requesting copies of the fund's Board and advisory committee meeting minutes. Often the meeting minutes can be as valuable to an investor for what is not included, as what is actually reported. At a minimum, such minutes can tell a fund investor how frequently the fund's internal oversight bodies are meeting, and the general seriousness ascribed by the administration team to strong fund governance. For example, if meeting minutes are not kept for investment committee meetings it

can be an indicator the committee review process is not given sufficient weight in the investment approval process. Meeting minutes can also provide important insight on the strength or robustness of the fund's governance activities. For instance, the meeting minutes of an investment fund may suggest the Board of Directors' oversight is mainly focused on meeting its prescribed administrative requirements, such as approval of standard administrative resolutions. They may include very little detailed discussion of key fund operating issues (such as details regarding the fund's operating budgets, accounting, and performance based measurement of the fund manager's day to day activities). The absence of evidence of Board-level discussion/debate on fund operating activities should typically be considered a red flag regarding the strength of the fund's oversight.

As is the case with fund financial statements, investors should request copies of the fund's final, approved meeting minutes. Preliminary or draft minutes will only leave the door open to questions and uncertainties regarding what has ultimately been discussed and approved. For instance, one South American fund issued only preliminary minutes for a series of its Board meetings. Unfortunately, at a later date questions were raised about related party disclosures and the approval sequence of one of the fund's investments. Since the draft Board minutes had never been officially ratified by the Board, there was no definitive record regarding the Board's approval of the particular investment being questioned. To avoid these types of issues, all funds should strive for prompt approval and finalization of their meeting minutes.

Requesting Additional Information

In addition to the previously mentioned reports, investors can request that the fund manager and/or Board of Directors provide certain additional fund information on a regular basis. For instance, quarterly financial information can be very useful for fund investors, as it can help the investor identify and track important operating trends. Also, if the fund's financial statements do not contain sufficient detail on certain accounts or line item entries, it is important that additional detailed information be requested. In the past there has been more than one case of an SME fund whose audited financial statement lumped together various transactions into a single account line item (such as general investment receivables account). It was only upon further investigation

that it became clear that the account included unexpected or unauthorized components, (such as funds due from a related party, or additional fees being paid to the fund manager). The lesson learned is that any fund balances with more than nominal amounts should be accompanied by supporting detail.

Establishing Performance Benchmarks

Rewards for strong operating performance are often delivered through the fund manager's compensation. LAC's SME funds have historically been structured with management fees which include at least a flat, fixed annual fee based on total capital under management. Based on the operating track records of various SME type funds, this type of fixed fee structure is not always advantageous to fund investors. Because of the unique characteristics of the region's funds, performance driven compensation appears to be an increasingly important topic for LAC investors.

The specific types of performance benchmarks that can be used by investors to monitor a fund's activities, will depend on the operating characteristics of the fund and its investment manager. In addition to standard return measures, (such as return on fund capital or cash on cash returns to investors), operating related performance measurements may include:

- Day to day pipeline development activities (focusing on costs & time allocations)
- Pace of actual investment disbursements vs. the fund's initial fund projections
- Expense control achievements
- Level of account management responsibilities, by staff member

For instance, most fund managers regularly produce reports on their pipeline development activities for their Board of Directors. However, these reports usually cover only basic, generic information such as prospect names, type of industry and the projected amount of the potential investment. As such, a fund manager may report attending a dozen international conferences and seminars for the purpose of networking and deal development, and its pipeline development

report may show that it screened a total of seventy investment proposals in one reporting period. Yet, in actuality that fund may be dramatically less productive in identifying viable investment prospects than a fund which screened a much lower number of proposals, but which had a much more successful investment "hit" rate because it had focused its efforts on more fruitful local networking events. As such, for most investment funds, performance measures should ideally be geared to the *quality* of results, rather than simple quantity based measures.

Investor Use of Third Party Reviews

As mentioned earlier, the independent fund review process is an important oversight tool for all funds. Since an independent reviewer typically evaluates both the fund's activities and various governance related issues, it can be a particularly useful tool for a fund's minority or limited partner investor.

Key considerations for a fund investor regarding the use of a third party review process include:

- Make sure the reviewer is sufficiently independent of all related parties (both personally and contractually). It is critical to the oversight process that the reviewer is able to provide objective, frank feedback on fund operations without being intimidated, or otherwise influenced, by parties which may have a vested interest in the outcome of the evaluation.

- The scope of work on the assignment needs to be tightly defined and cover all significant risk management issues. Monitoring evaluation reports which provide a broad, but superficial level of review of fund issues are not particularly effective as a fund oversight tool. Fund investors are best served when the independent reviewer conducts an in-depth evaluation of the details of the fund's operations and investments.

- Make sure that enough time and resources are allocated to complete a comprehensive review, and that the fund manager is sufficiently cooperative. It can be quite challenging even for the best review professionals to complete a thorough, comprehensive evaluation within the short periods of time which are typically allocated for a review. When fund managers are not fully cooperative in the process, the challenge becomes that much more significant. In such situations, it is important for fund investors to take a direct role ensuring the reviewer has sufficient cooperation and full access to fund records.

- Make sure the reviewer, or review team, has an appreciation for the challenges and issues inherent in small and medium sized business financing. Without this they are likely to miss key risk factors during the review process.

1.3 FUND ACCOUNTING AND FINANCIAL MANAGEMENT

Two major components of a fund manager's administrative responsibilities are addressing the fund's **internal accounting issues** and conducting its **financial management activities**. Each investment fund has its own approach to handling these responsibilities. Based on the operating experience of a wide range of LAC based funds, the following are key management issues and concerns which fund managers have learned regarding these two areas of fund administration.

Stand-Alone Accounting

The practice of having an equity fund maintain independent, stand-alone accounts [3] is at the top of the list for best practices in the accounting and financial management area of fund administration. This reflects its importance to maintaining the financial and operating integrity of the fund's assets. As indicated earlier, the use of combined accounts typically creates problems, errors and/or added costs for the investment fund. For this reason, it is strongly recommended that the bank accounts and accounting records for each investment fund be managed on a completely independent and separate basis.

Fund Account Transfers

The maintenance of signing authorities for fund bank accounts and legal documents is a straightforward operating procedure. Yet, as noted previously, fund managers have learned through experience that it is an issue that can easily be overlooked during the fund's operating cycle. In addition to needing to keep signing authorities up to date, management also needs to make sure the fund's Board is fully advised on the establishment of all fund subsidiaries, bank accounts and any other entities to which fund assets may be transferred. As one example of how this can happen, there was an instance in which one LAC investment fund's Board approved a certain investment in a technology company. While closing the approved investment, the fund manager determined it would be more advantageous for the fund to hold the equity shares in the technology company in a separate, fund-owned subsidiary. Although the fund's Board was ultimately advised of the change in structure, it was not told that some of the fund's investment monies were going to be held back within the subsidiary for potential future subsidiary operating expenses. In the end, the Board not only did not actually approve the structure of the final transaction, but all of the investment fund's financial records and reports mistakenly listed the investment as a direct investment in the technology company's shares. In reality what the fund really owned was shares in a subsidiary which had rights to the technology company's shares (and a cash account with reserve cash holdings). Further, since the structure of the transaction had not been clearly reported to the Board, there was a lack of internal controls at the subsidiary

[3] Defined as bank accounts, treasury accounts and fund accounting ledgers.

level. Indeed, the questions regarding the overall deal structure were picked up only because an independent reviewer noted a transfer of the subsidiary's reserve cash to a money market account established in the name of an individual (rather than in the fund account or the name of its subsidiary). Based on these types of experiences, the region's fund managers have learned that it is important to implement policies and procedures which assure the fund is advised of all asset transfers.

Tax and Regulatory Reporting

Fund managers routinely do a good job at the onset of the fund's operations in assuring fund compliance with local regulatory reporting requirements. This includes all of the regular filings required from all investment funds by local or national investment oversight authorities. For instance, at the start of a fund, outside opinions are typically obtained from external accountants and/or independent legal counsel confirming that the fund has no tax reporting responsibilities. Indeed, given the public profile of some of the investors in LAC's SME funds, such comfort letters are an important part of a fund manager's initial financial management compliance efforts. Fund managers have learned, however, that assuring their fund remains in compliance with its tax and reporting requirements is an area which often needs strengthening. This reflects the fact that tax and regulatory laws and requirements often change over time. Also, some funds (especially regional funds) may find themselves doing business in different countries than was anticipated at the onset of the fund. For these reasons, processes need to be put into place to assure the fund is periodically confirming its on-going compliance with tax and regulatory reporting requirements. Given investors potential sensitivity to fund non-compliance with these issues, it is in the best interest of all parties that written compliance confirmations be obtained from third party experts with solid expertise in the particular countries in question.

Disbursement and Billing Procedures

Another administrative item LAC's SME fund managers have learned through experience is that once an equity fund has begun to actively invest its capital, the use of strong investment tracking procedures is critically important. Key procedures include assuring the fund has solid systems in-place for tracking and reporting on fund disbursements and collections. Problems can quickly

arise with funds which have not implemented standardized procedures for these issues, especially with regard to investment disbursement procedures. For instance, one LAC SME fund ran into problems when it began disbursing its investment prior to having received a fully executed shareholder agreement and without signed acknowledgements from the company confirming their receipt of the investment monies. After a significant amount of the fund's planned investment had already been disbursed, the fund manager learned that one of the partners in the investee company suddenly did not agree with all of the terms in the shareholder agreement and was refusing to sign the document. The problem was eventually resolved and the Shareholder Agreement was ultimately signed, but not without additional legal cost and significant worry by the fund. The lesson learned from this and other similar examples is that weak disbursement procedures can expose a fund to a significant amount of unnecessary risk. In fact, SME investment funds are best served by adopting policies which direct that *no* fund monies be disbursed unless and until the fund has confirmed the satisfactory receipt of fully executed investment documents. Those documents should also include properly signed acknowledgments from the investee company demonstrating its receipt of all investment funds disbursed. Ideally, confirmation that the fund has received a fully completed and enforceable set of documents should be obtained from local experts, such as an experienced local attorney.

From an investment collections perspective, it is important for investment funds to put standardized processes in place for billing their investee companies and to issue past due and default notices if payments fall into arrears. Whichever format the billing takes, key practices include completing all billing on a regular and timely basis, maintaining records for all bills issued and assuring that all billing related correspondence issued by the fund adhere to local legal requirements. It is also important to note that legal requirements for commercial investment collections and workouts can vary widely among the various countries within LAC. As such, investment funds which do not address these potential differences in their investment billing and collection processes can put the fund's investment (and perhaps even the fund itself) at great risk. Consequently, all fund billing and collection policies should be reviewed and approved by legal counsel that is intimately familiar with both commercial financing transactions and the specific legal requirements in the geographic location(s) of the investee company.

Management of Collateral and Other Investment Related Documents

A final issue to consider with regard to best practices for establishing strong "back-office" financial management procedures, is the benefit of adopting a reliable, cost effective system for tracking important investment related documents, especially those which are considered time sensitive. Examples of such documents might include key man life insurance polices, collateral liens on investment company assets, or credit enhancement documents issued in favor by third party financial institutions. Without such systems, a fund's investments may be subject to unnecessary added risk, especially if the fund manager forgets or is unaware of important documentation renewal dates. For instance, one LAC investment fund obtained a letter of credit issued by a local financial institution as additional collateral on a poorly performing investment. The terms of the collateral required that the letter of credit be renewed annually. However, because the fund did not have a centralized database that tracked the fund's investment related documents, the annual renewal requirement somehow slipped by the fund manager's staff. Unfortunately in that instance, the fund manager was not aware of the mistake until after the existing letter of credit had lapsed. As that one example underscores, it is important for SME investment funds to establish a basic tracking system for all investment related documentation.

Tracking Foreign Currency Exchange Risks

Most LAC SME funds operate with some level of foreign exchange currency risk. These can take the form of either direct or indirect risks for the fund. As an example of the former, one LAC fund manager believed there were business and financial benefits for making the fund's investments through independently formed subsidiaries. Consequently, on its first transaction, the fund's investment monies were transferred to a newly formed local subsidiary and converted into local currency. Unfortunately, however, the transfer occurred before the investee company was ready to begin drawing down the investment funds. As a result of the delay, the fund was exposed to unexpected (and unprotected) foreign exchange risk on the investment. Among the large number of LAC-based funds which make only dollar based investments, there can also be indirect foreign exchange risks, via the fund's operating cost base (e.g., having to pay local office operating expenses), and/or through its investee companies' currency exposures (e.g. share

valuation risks on companies which have large sales and operating exposure in currencies other than the dollar).

Due to the relatively high cost of formal currency hedging mechanisms, most SME funds do not implement structured foreign exchange risk management programs. However, some do employ less formal money management strategies aimed at reducing potential foreign exchange exposures. Depending on the specific currency risks of the underlying transaction, where feasible these might include:

- Currency conversion features in the fund's investment contracts.
- Acceleration clauses for especially volatile periods.
- Investing fund cash balances in lower rate, "safe haven" financial instruments.
- Diversifying the currency mix of the investment deals within the fund's own portfolio.

A principal lesson for all fund administration teams is to try to avoid unexpected negative "surprises" related to preventable foreign exchange losses. To do so, a fund's manager, Board and oversight committees should track the fund's various foreign exchange exposures on a regular basis.

1.4 SUPPORT RECEIVED FROM RELATED PARTIES

In some cases, the support received from parties related to the fund's management team can be very important to maximizing a small equity fund's impact and investment success. This support may include direct assistance from parties related to the fund's administration (fund manager, Board of Directors and advisory committee members), or dedicated grant funding targeted to support the fund's investment mandate.

For instance, in the case of one regional LAC fund, an affiliate of the fund manager was able to provide several of the fund's investee companies with marketing assistance and technical support for its efforts at entering the U.S. marketplace. This support enabled the company to access potential new export channels which they otherwise would not have identified. In another

example, a Board member of one LAC based fund was successful in putting one of the fund's investee companies in contact with a potential major new client. On another fund, the lead investor of an SME fund provided a substantial technical assistance grant for use in helping to prepare prospective investee companies for fund investments. In summary, there are many different ways for related parties to provide support to an SME fund. If managed appropriately, these types of direct and indirect support activities can be a very beneficial.

In order to appropriately manage support from related parties, it is important for a fund's administration to establish clear parameters for the contributions received. Recommended parameters include:

- All related party support should be provided on a fully transparent basis.
- If work or support involves any type of fee or cost, there needs to be confirmation that the costs are at market rates. The fees should also be openly disclosed to the fund's Board members for their approval.
- A major ingredient to successfully adding value to an investee company's operations is that the related party have sufficient knowledge and expertise in the support activities provided. There has been more than one experience in which related party entities have tried to provide investee companies with support using staff that was not qualified to deliver the level of technical assistance the company needed. The fund's Board needs to take an oversight role when any parties related to the fund or its management team become actively involved with the investee companies (especially is there are costs and fees involved).
- Based on the type of support transaction delivered, the fund should consider obtaining a "hold harmless" type of agreement from the investee company. This would deter claims against the fund if there were later disputes or disagreements about the support provided.

As a final observation, the provision of direct financial support[4] to investee companies by members of the fund management team is generally not productive and should be actively discouraged by a fund's investors. Even when extended with the best of intentions, such support

[4] (Including contributions via loans, guarantees, equity, or other means)

often raises questions about whether the fund's investment exposure would have been handled differently if management did not have a vested interest in the deal.

To help prevent these types of situations, a strong set of internal checks and balances is needed. Such controls can include mandatory insider disclosure statements, periodic Board or outside review of the investee companies' financial statements (for the purpose of identifying any related party transactions), and the inclusion of strong contractual protections in the fund management agreement. It is recommended that the latter include automatic termination language in the fund management agreement for any non-approved activities between an investee company and parties related to the fund manager.

2.0 FUND OPERATIONAL ISSUES

Operational activities range from identifying potential fund investment opportunities to structuring an investment deal and monitoring its performance, to exiting the investment transactions and, hopefully, recouping the fund's monies with a reasonable rate of return. To-date, the success of SME investment funds operating in LAC has varied widely. Some funds have done relatively well in their efforts at providing financing support to small and medium sized businesses in the region; others have not. Using lessons learned from a wide range of active LAC funds, following are key observations and findings related to maximizing the operational side of an SME fund's activities.

2.1 PIPELINE DEVELOPMENT

LAC's small investment fund managers have indicated that it is common for funds to underestimate the amount of time needed to bring a proposal from the initial pipeline deal screening stage to an actual investment closing. This trend appears to be due to a variety of factors. For instance, funds often prepare an "indicative" pipeline list as part of the capital fundraising process. However, many times the prospects identified on those lists have been dropped by the time the fund is capitalized and ready to begin operations. Thus, many fund managers find themselves starting their operating phase needing to essentially develop from

scratch a new deal pipeline. Complicating these efforts further is the fact that pipeline development activities may be conducted by fund management staff who do not have a large amount of experience (and, therefore, personal contacts) in many of the individual markets they are trying to develop. Another issue is that fund managers and fund Boards often underestimate the amount of effort needed to cultivate a good sounding project into a viable investment opportunity. Delays due to inadequate financial information, difficult investment term negotiations and slow legal documentation processes are not uncommon. Overall, as a result of these and other related issues, many LAC SME investment funds have faced higher than expected pipeline development costs and slower rates of actual investment disbursements.

With these issues in mind, following are several suggestions for investment mangers and investment fund Boards interested in maximizing the efficiency of the new investment development process.

Screening Tools

Many funds do not think much about, no less evaluate on a regular basis, the effectiveness of their deal tools. Yet, this can be an area which markedly improves a fund manager's efforts at pipeline development. For example, some funds record virtually all of the proposals they receive as potential investments. As a result, some very unrealistic and low probability prospects may pass through the fund's first screening stage and this can cost the fund a significant amount of unnecessary time and money. For instance, in the case of one LAC equity fund there was an explicit fund policy against the investment in companies which had a certain percentage of revenues derived from the sale of alcoholic beverages. However, two of the fund's pipeline companies had more than the allowed percentage of sales derived from those types of beverages. Ultimately, the projects were dropped due to the fund's investment guideline restrictions, but not until after the fund had spent time and resources on developing them within the pipeline. This type of problem has also occurred within other LAC SME funds, which suggests it would be beneficial for fund managers to tighten their screening processes so that proposals which do not adhere to all of a fund's investment guidelines are uniformly excluded up-front. Periodic review of the effectiveness of a fund's pipeline development screening tools would also be a worthwhile step for most funds.

Sources of New Investment Leads

LAC's SME funds have indicated that the most productive investment pipeline lists are those which have been built based on quality leads obtained through contacts with investors or other professionals in the targeted marketplace. For instance, one successful LAC SME investment fund generated all of its investment leads through a designated advisory committee whose members had excellent business experience and contacts in the South American country in which the fund was operating. In comparison, another LAC fund organized its pipeline development activities heavily around cold calling type activities and broadcast events (i.e., generalized industry conferences). Overall, these latter types of strategies seemed to produce much lower quality investment leads. Similarly, specialized investment "fairs" in which potential investee companies are invited to compete their business plans in front of potential investors have not, to-date, had a particularly good track record as a reliable feeder source of quality investment

opportunities. Although results depend on the specific competition, it appears the review assessments conducted at these types of events is not particularly rigorous, especially on financial and market issues. Based on these experiences, periodic review of the sources of a fund's investment leads is usually a productive exercise.

Tracking Staff Productivity

Many LAC fund managers track the total number of investment proposals they receive and use this number as a proxy for the level of fund pipeline development activities they have conducted. While this approach can provide some idea of general market interest, it does not provide a particularly good measure of the actual level of effort expended by fund staff on investment deal development. It may be that only a relatively few of the fund's potential deals were actually subject to in-depth, comprehensive review, while the majority of other prospects were given only cursory consideration. For this reason, experience suggests that a fund is better served to *de-emphasize* the number of proposals screened by the fund manager and focus instead on the efficiency and cost/benefit of the fund's deal development efforts. Based on the experience of various fund managers, this can best be accomplished by tracking and reviewing the level of staff effort dedicated to the pipeline process.

2.2 INVESTMENT LEVEL PROJECTIONS.

LAC's SME fund managers typically do an excellent job in preparing basic financial models to assess their investee companies' operations and expected investment performance. Yet, while many funds' models are well formed, a consistent problem encountered in the field has been the use of overly optimistic projections in the investment review process. In fact, the performance of many LAC SME investment funds would likely have been stronger if they had tempered the operating assumptions used in their investment models. With that in mind, the following are several best practice recommendations with regards to investment level financial modeling.

Company Operating Projections

It is standard practice for companies looking for investment funds to be optimistic in the financial projections they present to potential investors. For this reason the region's fund managers have learned that it is important for them (and the investment committees and Boards which oversee them) to "ground-truth" the investee company financial projections submitted to make sure they fit the market reality in which the business is operating. This ground truthing, or verification, process can be accomplished by comparing the key operating variables presented against known data for the investee company's industry and markets. Take, for example, the case of one LAC investment fund which made a sizable equity investment in an agricultural based consumer products company whose revenues were largely derived from export sales to the U.S. and Europe. The fund entered into the transaction based on a set of company prepared projections which forecasted enormous growth in top line sales, very significant upward swings in gross profit margins, and a very high projected net income to sales ratio (i.e. over 15% per annum). The company had been in business for a number of years, but had never achieved anything close to the levels of operating and net profitability that were projected. Subsequent to the fund's investment, the investee company failed to achieve both its projected sales and profitability numbers, and it quickly began to experience severe financial problems. As a result, the fund faced a relatively large and quick loss on its investment.

In retrospect, it appears that if the investee company's projections had been compared against available operating statistics for the company's industry, its extraordinary projected operating performance would likely have been noted as a major red flag on the transaction. Perhaps the fund would still have provided some investment support to the company, but given those red flags it more than likely would have been on terms which more appropriately reflected the clear risks of the investment (e.g., short-term secured lending).

The main lesson learned from that transaction and various others like it, is the importance of using all available industry data and market information to establish a realistic framework in which the investee company's financial projections can be analyzed. From that analysis any significant variances from industry standards and norms can then be addressed. Although some

companies obviously can outperform their peer set (i.e., due to certain competitive advantages or unique attributes), if a potential investee company is projected to do significantly better than others in its industry, it should be up to the fund's investment analyst (and oversight committee) to substantiate how that high level of performance can realistically be achieved.

When examining an investee company's financials, core variables that are useful in the financial benchmarking process include:

- Sales growth (which needs to be reviewed in the context of the overall size of the existing and projected market, as well as market competition issues).
- Projected gross, operating and net profit margins (which are reviewed both in the context of actual rates historically achieved by the company, as well as margins achieved within its industry).
- Operating related balance sheet ratios and indicators (e.g., liquidity, current account turnover ratios and debt service coverage ratios).
- Cash flow velocity.

Finally, the region's fund managers have learned through experience that it is also important to explicitly test the viability of the fund's expected exit mechanism on a proposed investment. For example, if a fund assumes its equity share will be bought back by the company (or otherwise taken out) in year 4 of the investment, it is extremely important for the fund to examine the company's ability to access the projected take-out capital needed. In most cases this will require the fund to complete a realistic assessment of the company's projected balance sheet, as well as examine the terms and conditions being offered in its local financial markets.

2.3 DUE DILIGENCE ON POTENTIAL INVESTEE COMPANIES

In conjunction with realistic financial modeling and investment structuring techniques, conducting solid due diligence on a proposed investee company is probably an investment fund manager's most important responsibility. It is clear that managers who cut corners in this area

are likely to experience very poor investment portfolio performance. Given the importance of sound investment due diligence to an equity fund's success, experience suggests it should be a major area of focus for not only the fund manager, but also the fund's Board and investment advisory committees. Following are several general suggestions for investment fund managers and their oversight committees based on the past experience of other SME funds.

Basis of the Due Diligence Review

To be successful with investment placement, a fund manager needs to understand at a relatively deep level the specifics of the targeted company's operations and financial reporting. Unfortunately, a not uncommon misstep by some managers and investment analysts is to believe they understand the operating side of a company based mainly on conversations and information provided by the business owners themselves. As a result, it is very easy for them to misjudge critical operating issues and this can put the fund's investment at great risk.

As an illustration of this, take for example a LAC SME fund which identified a seemingly very attractive opportunity with a South American consumer products company. In addition to interesting projected financial returns, the company was expected to generate positive social benefits in a very high poverty area. While conducting its pre-investment due diligence, the fund manager identified there had been a recent national public health scare about a food product that represented one of the investee company's main sources of revenue. The fund manager spoke with the company and certain related parties about the issue. It was reassured the national government had moved aggressively to address any health concerns with the product, that the scare had passed, and that consumer confidence in the product was on the upswing. This issue was identified as a risk in the investment approval memo sent to the fund's Board, but there was no further inquiries or discussion on the topic at either the fund management or Board levels. Not long after the fund's investment was made, it was determined the company was experiencing serious cash flow problems. Over time, the fund manager learned a major contributor to the cash flow problem was the company's sales return policy. Specifically, the investee company had, as was customary for its industry, a relatively liberal product return policy. For that industry, it was standard practice to provide retail customers with the right to return any unsold product for up to

two years after the product was shipped. What the fund had failed to realize in its initial analysis of the company, was that its reported sales for the particular food product in question had not yet seen the full effects of the national health scare. In fact, due to the scare, a higher than average percentage of inventory sitting with retailers was being returned to the company (through deductions and credits on new sales invoices) and this lag effect had to be factored into the company's projected income and cash flows. In hindsight, the fund manager probably could have avoided the problem by obtaining a copy of the investee company's standard sales contract, examining the return allowance account in its sales records and/or by more closely examining the company's accounts receivable base.

This type of misstep is not unique to that one investment or any particular fund. Another LAC SME fund encountered a similar type of problem on an investment it made in a company marketing a natural resource product to industrial users. In that instance, the fund manager used the investee company's data on projected market demand when it modeled the fund's investment. It did not question the company's assumption that it could grow sales very quickly based on its projected product cost advantages. It was assured, mainly by the company itself, that the firm could compete successfully and quickly gain market share based primarily on low price (due to its expected production cost advantages). It was only after the fund's investment was made that the company and the fund manager realized that product *quality* was even more important than price for the customer base being targeted. Unfortunately, due to various technical issues, there were constraints on the level of quality of the product the company was able to sell. This miscalculation cost both the company and the fund very significantly.

Based on these and other similar examples, a major lesson learned to-date is that there is no such thing as an investment fund having *too* much detail on a potential investee company. For this reason, fund managers are encouraged to complete as comprehensive an evaluation as possible of each proposed investment. Such evaluations should include, at a minimum, review of the company's standard sales contracts and payments terms, examination of its contingent liabilities, review of legal agreements the company has entered into, examination of the company's accounts receivable and accounts payable lists, detailed assessment of each of the company's

products or main sources of revenue and detailed scoping of all potential market, legal and regulatory issues which could impact the company. Fund managers are also wise to specifically ask and obtain back-up information on off-balance sheet liabilities, claims and return allowances. It should also consider situations in which there may be "hidden" value within a company's balance sheet (such as when important business assets have been depreciated on an accelerated basis). It is particularly important that the fund's oversight bodies look closely at the due diligence information presented, make sure the source of the information is clearly identified and determine if there is sufficient back-up documentation for all important investment assumptions.

Compliance Related Due Diligence

There are three major compliance related issues which require review as part of a fund's standard due diligence process. These are (1) the potential investee company's conformance with all portfolio related guidelines, (2) the company's compliance with all applicable laws and regulations, especially environmental and labor laws, and (3) the transaction's adherence with anti-money laundering statues.

(1) Confirmation that an investment complies with a fund's internal investment guidelines is typically a straightforward exercise. The by-laws of most funds provide explicit guidance regarding the specific types of investments the fund manager can, and cannot, make. For instance, many LAC SME funds will have a "prohibited list" of investments. This list specifies various types of businesses in which the fund is not allowed to invest. Examples of prohibited types of enterprises include gambling related operations and weapons manufacturing. Issues for fund managers to be mindful of in this review process include businesses which are engaged in prohibited list activities as a non-direct line of their operation (i.e., through a subsidiary), and companies which enter into prohibited list activities subsequent to the fund's investment.

Operating covenants in a fund's investment agreement can provide a contractual ability to exit transactions which do not meet a fund's internal guidelines. However, in practice, such clauses can be difficult to enforce once a fund's investment has been fully disbursed. For this reason, strong pre-investment due diligence on the project sponsor group's background is critical. In

addition, the inclusion of personal recourse clauses can be useful in improving the enforceability of standard operating covenants.

(2) Most LAC-based SME funds also review their potential investments to confirm that they adhere to all local laws and regulations, and all applicable international treaty agreements. Ideally, such reviews are completed both prior to the fund issuing its investment commitment and over the life of the transaction. In this area of compliance related due diligence, some funds rely heavily on sponsor provided statements of compliance. Self-declarations of compliance are a useful starting point in the review process, but in most cases, need to be cross-checked through other, independent means. For instance, in situations with potentially sensitive environmental or social issues, many fund managers will also require independently prepared impact assessments be completed as well. A fund might also require, as a condition of its investment, that an investee company regularly submit copies of all licenses and operating permits. In this way the fund can maintain a clear, written record of the investee company's regulatory approvals, and monitor any conditions which may accompany them. Based on the experience of past funds, taking this type of engaged, proactive approach to confirming portfolio companies' legal and regulatory compliance can add directly to an investment fund's net return.

(3) Economic globalization and the rise in global terrorism have increased many governments' focus on preventing illegal financial activities, such as money laundering. For instance, both the U.S. Bank Secrecy Act and the U.S. Patriot Act 2001 set out specific provisions for financial institutions on anti money laundering requirements. As a result of these and other similar initiatives, it is important for all LAC SME funds to be sensitive to the potential of money laundering or other illicit activities being conducted by companies in their investment portfolios.

For most transactions, the review process for these types of activities should be conducted both up-front and during the life of the transaction. Up-front, the primary objective of a fund's initial scoping exam is to complete a risk based assessment of the transaction. In this type of review, various factors are evaluated to determine the level of risk that the proposed investee company could be engaged in illicit activities, such as money laundering. Based on the results of the

initial assessment, the fund manager can then determine if a more detailed investigation is warranted.

For example, when completing an initial scoping assessment to determine if money laundering is a risk concern on a proposed investment transaction a fund manager will consider:

Industry/Business Type	Is the investee company engaged in a business which involves large or frequent transfers of cash or other liquid assets? Is it the type of business which has, on an on-going basis, rapid turnover in its cash accounts? Does the company operate in an industry which has been red-flagged as a high risk for money laundering problems?
Business Structure	What is the legal structure of the investee company? Does it operate through off-shore subsidiaries or through a heavily layered corporate structure? Does it make use of off-shore bank accounts? Is it registered in countries which are known for weak money laundering controls? Does it rely on transfers (and transfer pricing) to subsidiary companies? Is there a high level of wire transfer activity to overseas accounts?
Sponsor Background	Who are the key players at the investee company (legal owners, as well as and "shadow owners" who may be directing company operations, but holding their ownership interest through other individuals)? Is there background information available on all key principals? Are the key principals established members of the local business community? Are there any red flags identified in the individuals' backgrounds (such as criminal convictions, unexplained gaps in background, history of legal conflicts, or association with questionable groups or organizations)?
Sources of Equity	What is the source of the project sponsor's equity in the company? Can the source of equity be traced and confirmed? Is the equity the result of recent or unexplained increase in the project sponsors' personal wealth?

Ideally, the outcome of the initial review process will be recorded in written form (e.g. through a checklist format), and shared with the fund's Board or investment oversight committee. Since circumstances can change over time, it is also important for fund managers to remain alert, post-investment, for signs of investee company involvement in money laundering or other illicit activities. Finally, in light of this risk, it is also critical that all fund investment documents

contain clear exit language for the fund, in the event any illegal activities are confirmed post-investment.

Financial Statement Review

It is widely recognized that the quality of the financial statements prepared by LAC SMEs can vary widely. In fact, problems with financial statement quality can be considered something of an "industry hazard" for SME financing. Unfortunately, there are no easy answers to this issue. To-date, some LAC funds have sought to address the problem by hiring their own outside accountants to review, and as necessary, revise (or even compile) a potential investee company's financial statements. Others have required as part of their investment commitment that the fund be able to designate a representative of their choice to take over as the company's controller. While good ideas, it appears that, to date, these types of strategies have not proven to be particularly effective at improving either investee companies' financial management controls or their financial reporting.

Consequently, it is critical that fund managers include questions about financial statement quality as a potential risk issue in their due diligence process. Unless there is a high level of comfort with the quality and integrity of the data presented in the investee company's financial statements, a fund should use the information presented as only one tool in its investment review process. Where possible, quality issues need to be identified and addressed through the fund's investment terms and structure.

Suggestions for identifying and addressing quality concerns on investee company financial reports include:

- Be alert for financial statements which do not balance, or which use unusual entries as "plug" type figures to get them to balance. As rudimentary as that may seem, it is surprising how often this can occur with investee company statements. In particular, plug like entries found in the company's shareholder equity account should always be considered a potential red flag on the investment. Funds considering making equity type investments based on such statements need to proceed with extreme caution.

- If there are questions about the potential integrity of some of the financial information presented in the statements, request additional back-up detail, especially on those accounts which are most critical to the fund investment risk. For instance, if inventory turnover is a critical aspect of the company's operations, look at things like the breakdown of the inventory valuation presented and the company's internal processes for inventory management and valuation. It would also be important to conduct an actual physical inspection of current inventory supplies.

- Whatever the company's operating or industry profile, focus as much attention as possible on those accounts which are critical elements to company cash flow. If the investee company is experiencing cash flow problems (as many often are) it is very important for the fund to do both pre and post-investment reviews on the company's cash flow accounts. That means looking at and testing the back-up for those accounts, and looking back over time to get a sense of the actual flow of funds through company accounts.

2.4 DEAL STRUCTURING

The key to successful investment deal structuring is identifying and addressing the main underlying risks on a transaction. While this is true on any investment deal anywhere in the world, due to the relative novelty of its private investment SME financing vehicles it is especially important within LAC. Investment funds which appreciate the different cultural perspective LAC small businesses typically have toward equity investments, generally do a better job in structuring their investment transactions and have better investment portfolio results. Alternatively, funds which set out simply to "prove the case" for the use of private equity financing in the region, almost irregardless of the underlying financial condition of the investee companies, can be expected to have very poor investment results.

The differences in the two types of investment structuring philosophies are notable. For instance, the manager of one LAC fund identified an opportunity to provide financing to a company which had not only strong financial return potential, but also potentially important job creation benefits. However, the small business was very undercapitalized and had been operating on a partially informal basis (meaning its financial records where not fully regularized from a tax and accounting perspective). After confirming the underlying business itself was strong and its market potential was positive, the fund manager negotiated a multi-tiered investment in which the fund made a small direct equity investment in the company's common share capital, with part of the proceeds used by the company to fully regularize its accounting records. The remainder of the investment was structured as part convertible debt and part secured (collaterized) loan. The terms of the quasi-equity called for the convertible loan to convert into equity on a staged basis upon the company's achievement of specific financial performance goals and compliance with the fund's operating/reporting guidelines. This type of tiered, staged investment is the kind of adaptive financing often needed by LAC small businesses. It helps to provide the small business with access to financing on better terms than it could otherwise obtain, addresses certain key risks on the account (under capitalization, lack of full regularization of accounts) and provides the fund with some of the potential upside on the business risk.

Pricing

Other important considerations from an investment structuring perspective are establishing appropriate pricing and investment terms. Regarding pricing, a fund manager is challenged with having to balance investors' expectations about their fund's overall performance against local market terms and the investee company's ability to pay. From a local perspective, it is very important for fund managers to consider the terms and pricing of formal, as well as informal channels of financing. Investments which are priced and structured on terms that are overly generous run the real risk of not being viewed as "serious" financing transactions by the recipient businesses (e.g. they are instead viewed as soft or grant monies). Also, as noted previously, when investing into a business, investment funds must carefully consider the viability of the fund's proposed exit. For these reasons, it is important that the fund remain updated on the availability, rates and terms required by other sources of financing in the local markets in which it is investing. Periodic surveys of formal financing channels (e.g., local banks, equipment dealers, other development financing groups), as well as informal sources of funds (unregistered money lenders, loans from associates) is useful.

Effective transaction pricing decisions will also reflect the different stages of risk inherent in a proposed transaction. For instance, one SME fund was assisting an early stage agricultural products company in South America by providing it with very short-term commodity contract financing. In doing so, it was careful to price its short-term advances at a market level. This reflected the fact that, because of the investee company's limited operating track record its main challenge was not pricing, per se, but rather obtaining access to the level of trade financing needed. The investment fund manager wisely recognized that market rates were not the problem and, therefore, priced the deal with healthy enough margins to help offset the short-term nature of the financing. In comparison, another regional equity fund was involved in a very similar type of investment transaction, but priced its financing at a rate which was at (or even slightly below) the local market rates charged for even a long-term, secured term loan. On that transaction, the fund did not cover either the real risks on the short-term deal, or all of its costs of underwriting and managing the investment.

Other important issues to consider when establishing investment pricing levels are currency exchange factors and the possibility of external taxes or other fees being charged on the financing. With regard to the latter, in LAC it is fairly common for local governmental authorities to tax certain financing incomes, such as loan interest income. Even in those jurisdictions in which such taxes are not currently levied, there is always the possibility they could be implemented during the course of the fund's investment. For this reason, it is important that the fund's equity and loan agreements include specific provisions which require the investee company to pay all financing related fees and taxes. Although the actual effectiveness of such clauses has not been well tested by the region's fund managers, the language can at least provide an investment fund with a first line of defense against unanticipated transaction fees and charges.

As noted, many LAC funds have tried to address currency exchange related risks by providing only dollar denominated investments. In recent years this appears to have been a fairly effective operating strategy in many markets. Obviously, however, this could change fairly rapidly if there were a rapid devaluation of the dollar. As a result, going forward, informal hedging strategies may need to be employed with greater frequency by a greater number of SME funds. For instance, if certain transaction exposures were large enough, a fund may wish to consider using its cash management activities to essentially "match-fund" certain assets. Or, it may wish to consider diversifying its investment exposures to several key currencies (rather than holding a completely dollar denominated portfolio), and/or diversify its investment portfolio to include a balance of different currency exposures. .

Deal Terms

With regard to the investment terms employed by SME funds, best practice considerations will vary according to the nature of the specific investee company and the type of financing provided (e.g. debt, quasi-equity or equity). For direct equity share investments, it is important that the terms of the investment agreement include strong, workable shareholder protection mechanisms. To date, common clauses used by LAC SME funds include minority shareholder voting rights, anti-dilution clauses and protection against unfavorable related party transactions. When structuring protective rights clauses, experience indicates it is critical they be established so they

can be readily enforced. For example, one equity fund took a minority common share position in an investee company required the company to modify its shareholder agreement so the fund had the right to veto any insider or related party transactions which were brought before the company's Board. Although this sounded like it would provide the fund with strong protection, in actual practice the mechanism proved to be rather ineffective. Management of the investee company did enter into related party transactions, but simply did not bring them before the company's Board for approval. As a result, the investment fund was not aware of some of these dealings and did not have an opportunity to exercise its veto voting powers.

As basic as it may seem, there also have been a number of instances in which funds have established contractual exit clauses in their investment agreements which were beyond the investment fund's own contractual dissolution date. Clearly, all loan and investment contracts should mirror the exit commitments established under the fund's own shareholder agreement with its investors.

Another investment terms/structure issue, which is important for fund managers to consider is the inclusion of assignability clauses in all fund debt and quasi-equity agreements. These type of clauses provide the fund with the ability to freely transfer or sell its underlying note (such as if the investment ever enters into a restructuring or workout situation). Similarly, a fund which has made more than one investment to a company (or related group of companies) should always seek to cross pledge and cross default all of its investments.

Finally, for all types of fund investment instruments, obtaining both affirmative and negative covenants from the investee company is always important. Such covenants might include specific contractual requirements for providing a minimum amount of financial and operating reporting, to restricting certain environmental and social impacts, to refraining from certain insider type transactions. Assuming they are effectively monitored and enforced, warranties and covenants can be invaluable in SME financing.

2.5 MONITORING AND SUPERVISION OF INVESTEE COMPANIES

Monitoring the performance of an investee company and the results of a fund's investment is a critical fund management function. One of the first components of that responsibility is monitoring the use and application of the fund's investments. Indeed, experience indicates it is critical for fund managers targeting LAC SME companies to establish firm, well documented procedures covering both the disbursement and use of the investment fund's money. In particular, in those cases in which fund monies will be used for construction or equipment/plant upgrades, phased implementation of certain business lines, or for general working capital purposes, it is very important for fund managers to maintain a level of oversight over the flow and application of the fund's investment monies.

The experiences of several different LAC funds have made it clear that when little or no tracking on the use of investment monies is done by the fund, problems and questions inevitability emerge. For example, at one LAC SME fund it was not until the investee company had received most of its investment money that the fund learned the company had not yet established separate bank accounts in its own name. Instead, the fund's monies had been transferred into the personal account of one of the company's owners (who happened to have other active business ventures as well). In another case, a fund invested money in a certain investee company under an agreement which specified some of the fund's money would be used to implement certain environmental and health and safety improvements. The investment fund monies were disbursed, but instead of purchasing the required equipment, the company used the fund's money for other, general working capital purposes. Since the full amount of the fund's investment had already been advanced, the fund manager had very little direct leverage in the situation, and the required equipment was not implemented. In that particular case, as well as in other instances, investments were also made to investee companies for general working capital purposes, but there was no firm confirmation on how those funds were actually used or applied within the business.

Based on these and other, similar experiences, it is clear that disbursement tracking systems are an important, often overlooked component of the investment management process. From a best

management perspective, it is recommended that a fund maintain a clear schedule with the investee company on how its investment funds will be utilized; in which account(s) the monies will be transferred or held; and, in cases of phased investment disbursements, which benchmarks the investee companies need to reach in order to obtain any remaining funds. In addition, another good practice which has been employed by some of the region's investment funds has been to disburse the investment monies into a dedicated account which requires dual signatures to access (including one signature from the fund manager). In other instances, some SME funds have successfully used draw down accounts, in which specific amounts of a pre-determined budget are disbursed by the fund manager upon receipt of a disbursement request and satisfactory back-up documentation. Alternatively, another strategy is for the fund to disburse its investment monies directly to the investee company's suppliers (rather than the company itself). This provides the fund with a greater level of control of keeping their investment monies from being diverted to other uses.

Whichever system best fits the particular type of financing support being provided by the fund, a key lesson learned is that solid monitoring of the application and use of the investment funds disbursed is always needed.

Site Visits

LAC's SME fund managers have learned through experience that in order to maximize the potential returns on their investment they must take an active, hands-on approach to the monitoring and supervision of their investee companies. Site visits to investee companies by fund management staff play a critical role in this process. In fact, experience indicates that funds which take a passive approach to this aspect of investment management (such as not regularly visiting an investee company; relying too heavily on company supplied information, etc.) consistently have weaker investment portfolio results. Given the importance of an effective site visit program to an investment fund's results, following are general observations on how to make the site visit process an effective and more robust management tool.

- **Scope of visit** – It is easy for investment professionals to fall into the habit of assuming they have already learned all they need to know about a company's operations from a prior visit(s) or prior communications with the company. When this happens, it is easy to conduct a site visit not expecting to learn much about the company's operations. For instance, one fund made an investment in an investee company located in a somewhat remote location. This meant the fund manager's visits to the plant were relatively infrequent and it took a fair amount of time and money to complete. On the investment fund's second trip to the company's plant, its investment officer indicated he had already been through the operation once before (a year earlier) and that he expected the company tour of the production facility would be very brief. Fortunately, another member of the site visit team insisted the team complete a more comprehensive review of the plant, because during that visit the fund identified several significant changes had been made to the company's manufacturing lines. The changes made had implications on the investee company's use of the fund's investment monies, its general marketing strategy, its operating costs, its compliance with its operating and environmental permits, and the health and safety condition of its workers. If the investment officer had not completed the full, step by step review of the facility, many of those issues would never have been identified.

  The lesson from this example and others like it, is that no matter how many times an investment professional has been to a site, it is essential for them to approach the visit with an open, objective perspective and to make sure that the scope of the visit is geared toward learning everything currently possible about the company's operations.

- **Questions** – as stated previously, an investment professional can never have too much information, or too many details about an investee company. For that reason, company site visits provide an excellent opportunity for fund staff to increase the level of understanding about the company's operations, and cross-check information which may have been provided earlier and/or by others. There is often great benefit to re-asking certain questions in the field, as sometimes other investee company personnel can

provide responses which give the fund manager a new insight to a company. To conduct an effective site visit it is important to continually ask questions, even on what may seem like basic issues.

- **Time Allocation** – despite the importance of site visits to effective investment management, they are often scheduled to be completed very quickly. It is not uncommon for a fund manager's representatives to have to move through a very busy site visit agenda in a very compressed period of time. In such situations, the best recommendation is to slow down the review process, even if it means spending an extra day or two with the company. It is also important that management staff slow down and direct the pace of their tours, to make sure they are getting as much detailed information as possible for their investors. Too often management personnel may miss important issues, or even be misdirected about a company's operations because there was not enough time spent with either the company or others in the local marketplace. For these reasons, whenever possible, a fund's manager should allocate sufficient time for comprehensive site visits and make sure the visits include meetings with local contacts (conducted outside of the presence of the investee company).

- **Accounting records** – Fund management staff do not typically audit their investee companies, but review of a company's accounting books and records should nevertheless be a standard part of every site visit.

Suggestions for fund management staff in conducting an accounting records review include:

- Use the accounting review process to identify the specific policies and procedures used by the investee company for managing its books and records. Confirm that the processes seem logical.
- Look for obvious trends within the company's accounting records. This can help in the identification of unusual transactions, such as deals with related parties.
- Ask to see the back-up for key operating account entries. For instance, examine random samples of the company's customer invoices. This can provide a much better idea of how sales (and related discounts, returns, etc) are being managed. Since sales practices can change frequently this is a process which needs to be done during every visit.
- Always look at the accounting ledgers for accounts receivable and accounts payable. While doing so, look especially for concentrations of "stale" accounts, unusual discounting practices and related party/insider transactions.
- Make copies of the key ledgers (such as A/R and A/P), and at least a representative sample of other back-up documents.

◆ **Operating reports** – While on site it is also very useful ask to review and make copies of other important company operating records. For example, for certain investee companies safety records and worker accident reports are important operating documents. Rather than simply rely on the company's verbal representations about accident data, ask for copies of their safety reports. These reports can give an idea of worker safety conditions, as well as the level of priority which the investee company's management places on such issues. Also important, is review of the company's local permits such as its operating certificate, environmental permits and any labor related permits and certificates. Staff members may conduct a visit to an investee company and miss these items, simply because they assume the permits they received from the company when their initial investment was made still apply. As a number of funds have learned, there are often compliance conditions associated with the original permits which the investee company may, or may not, be meeting. Also, the investee company's operations may have

changed post-investment (which can trigger new permitting requirement). For these reasons, it is important to update this information at each site visit.

2.6 FOLLOW-ON INVESTMENTS

It can be challenging having to decide whether or not to commit additional fund resources to an investee company via follow-on rounds of financing. It is not always clear whether an investee company is a true "winning" investment which simply needs a little more capital in order to reach its potential, or a failing prospect which instead represents a scenario of putting good money after bad. These types of management decisions need full and careful review. For instance, one small LAC investment fund invested in a very promising high tech agricultural start-up operation. Using the funds raised in its first round of financing, the company successfully established a steady stream of monthly production output and a small local customer base. At the same time, however, it continually missed both its initial and revised financial operating projections due to unexpected production problems and unanticipated shifts in its customers' preferences. As a result, the company began to experience cash flow problems and the investment fund and its co-investors were approached for a second round of financing.

The company's investors eventually agreed to provide the additional financing and the company is still operating. However, it continues to struggle with market issues and difficult operating cash flow conditions. Although its technology is "working", questions remain about the company's ability to achieve the scale of operations necessary to remain viable and return the investors' capital.

Since every investment is different, there cannot be one, standardized process for determining whether a fund's follow-on investment is prudent. Nevertheless, there are certain issues and questions for a fund manager to consider when evaluating such requests. These include the following:

- How well has the company performed relative to the projections and plans presented to the fund at the time of the initial funding? Did the investee company's management correctly anticipate key operating issues, such as unit production costs, sales channels, market demand and the business' cash flow needs? If not, why, and is it reasonable to assume that management's past mistakes will not be repeated going forward?

- For companies which are growing rapidly and appear to be potential investment "winners", is it reasonable to assume they can access additional growth capital, and would the amount of follow-on financing which is under consideration be sufficient to get them to the next stage of their development? Or, will the company continue to be hamstrung, even if they raise the amount of capital currently under discussion?

- Is there a clear schedule for how the added funds will be used within the operation? Will any of the follow-on monies be used to bail out other investors, and/or the company's owners?

- Are the pricing and terms of the proposed follow-on capital fair relative to the stage of the investment risk? Are second (and potential third, fourth…) round investors receiving the same returns as earlier stage players? Is it reasonable to assume a new investor would proceed with an investment at the same terms and conditions?

- Is the increase in capitalization justified by the investee company's underlying value? Would the increase cause the fund's investment to fall below what could be expected to be a reasonable return for the designated investment timeframe?

- Is the strongest rationale for advancing follow-on monies that the fund is trying to "save" its initial investment? If this were a brand new investment opportunity, would the fund proceed with the financing?

2.7 TURNING AROUND COMPANIES

Fund managers of small investment funds recognize that equity investments in SMEs can be very risky. The businesses they finance are often relatively new and/or are not particularly well capitalized. Also, as discussed previously, the depth and quality of the financial information they produce is not always satisfactory. Further, the relatively early stage of development of

LAC's equity markets makes the identification of viable investment exits for early stage equity investors that much more challenging.

In this context, the fact that all fund investments will not perform exactly as expected is essentially a basic operating premise for all LAC investment funds seeking to support SME enterprise development. Although some fund managers will have a lower rate of problem companies in their investment portfolios, it would be unusual for a fund not to have at least some investee companies which did not perform as well as initially projected. Consequently, the challenges associated with assessing and turning around troubled investee companies is an important part of a LAC investment fund's operations.

Business turnarounds and restructurings often require specialized professional expertise and should always be subject to strong oversight. In approaching potential investment restructuring opportunities, fund management staff (and the fund's Board/administrative team) need to carefully consider the direct, as well as indirect, costs and benefits of the transaction. In particular, in work-out or restructuring situations it is critical for the fund manager to engage experienced local counsel to guide it through the legal process. Innocent, well meaning missteps by fund managers can be very costly, as they may trip unexpected liabilities against the fund, its managers and/or even its investors.

The issues associated with turning around a troubled business will vary from company to company. There are no set guidelines for assessing a troubled company's viability. However, from a basic operating perspective, there are several core issues which fund managers and their oversight committees should keep in mind when considering turnaround scenarios. These include:

- Be on the lookout for early red flags or other warnings on fund investments. Early detection and intervention is often the best, most critical ingredient for successful account management. This can often be made more difficult by the sense of denial which often occurs with troubled companies.

- At any sign of potential trouble fund managers should make it a priority to obtain the company's financial statements and copies of other important investment related documents. Generally, funds should resist spending time and energy on the turnaround of companies whose financial condition is either not clear or of questionable reporting.

- Establish clear, formal lines of communication with the company.

- Consult with local experts, especially experienced local counsel and have them prepare an objective assessment of fund options, including any potential liabilities. Do not take control of a company, legally or operationally, without having received a complete written legal analysis of the risks of fund ownership.

- Establish realistic budgets on the potential costs of the turnaround as part of a general cost/benefit analysis.

- Provide non-financial support, as possible and prudent.

2.8 LIQUIDATING COMPANIES

Sometimes restructuring or turning around an investee company does not work as hoped. Once it becomes clear that the investee company is not viable, a fund manager must take those actions necessary to recover as much of the fund's investment as possible. The first and most important step in this process is determining all of the fund's options on investment recovery. This process should almost always be guided by a written assessment of the fund's situation, prepared by legal counsel experienced in the company's particular location. This written advice should briefly summarize (a) the legal status of the fund's investment documents, (b) the legal rights and remedies the funds has under its investment documents, (c) realistic estimates of the time and

expense which will be required for the fund to proceed with liquidation and (d) all potential legal risks and liabilities the fund could face in the liquidation process.

Fund managers need to be particularly wary of the latter risk – claims being made against the fund as a result of an investee company liquidation. Well meaning, but inappropriate steps by fund representatives in the asset recovery process could result in claims against the fund, its fund manger or even its limited partner investors. Such claims could be made by a wide range of parties, including the investee company's other investors, its workers, its creditors and/or local regulatory authorities. For this reason, as a general rule, a fund should never take a controlling interest in an investee company's assets without first obtaining the written advice of experienced local counsel.

In addition to obtaining written legal advice, when faced with a liquidation scenario a fund manager must act to locate and, as possible, protect all available company assets. Assets may consist of cash, real estate, inventory, accounts receivable, fixed goods or even intangibles. For instance, one SME fund made a quasi-equity investment in a South American consumer goods company which ultimately failed. Once it became evident the company would need to be liquidated, the fund's manager worked actively to insure that not only the full value of the company's receivables and inventory base was accounted for, but also the value of the company's brands, logos and exclusive distribution contracts. In that particular case, the fund's pursuit of the less obvious intangible assets ended up giving it an advantage over other investors in the liquidation process (other investors mistakenly assumed the company had no net value). Indeed, while often overlooked, items such as special licenses, distribution agreements, branding and/or company trademarks can provide a fund with important liquidation value.

Finally, once it is clear what assets may be available from a liquidating company, an investment fund should obtain written valuation estimates from a qualified third party(s). These estimates should describe the forced sale value of the company's assets, and include the projected costs of liquidation (e.g. legal cost, auction expense, broker fees, etc). It is also important to include realistic estimates of the time which will be needed to complete the liquidation.

Regarding exits on traditional debt related instruments, management issues are more straight forward. Key considerations for fund managers include making sure pay-off amounts are properly calculated, collateral documents (if any) are held in place until pay-off funds have cleared any necessary preference periods and the investment's legal documentation is closed out, as necessary.

2.9 PORTFOLIO DIVERSIFICATION

There are any number of ways an investment fund can diversify its portfolio. These include using basic parameters such as company size (micro, small, or medium); company type (by sector and/or industry position; start-up or well established); investment size and type (debt, equity, quasi-equity, guarantee; local currency or other); and, geographic location (within certain regions of one country; among the countries in one region). For some funds, portfolio diversification criteria are established within the fund's investment guidelines. In other instances, a fund manager may establish its own diversification strategies, or goals for the portfolio under its management. And, in some situations, a fund manager may decide to move in a less structured manner and respond opportunistically to investment opportunities as they present themselves. From an operational perspective, the main considerations for successful portfolio diversification are conducting a sufficient level of tracking (both among fund commitments and prospective new deal opportunities pipeline), maintaining a satisfactory level of reporting to the fund's oversight bodies and its investors, and weighing inherent risk trade-offs.

SUMMARY

This best practices paper provides detailed insights into many of the administrative and operational issues associated with LAC's SME private investment funds. Using the findings of various past fund reviews and actual investment case examples, the paper provides investment managers, fund Boards and fund investors with additional tools to help promote the successful implementation of non-traditional private financing for small and medium sized businesses throughout LAC. Experience suggests that SME fund managers that take an adaptive approach to their investment management activities will have the best odds of success within their respective markets.